The value of rental deposits

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Abstract

Purpose – This paper has two aims: to consider the negotiating strength of landlords and tenants in lease negotiations; and to calculate the level of deposit which is necessary to mitigate income risk.

Design/methodology/approach – The paper reviews the existing literature on the negotiation strength between landlords and tenants in different stages of the property cycle; investigates the well established deposit system in South Korea for lessons that might be applied in the UK; estimates the appropriate level of deposit using simulation methodology, given different states of the market; and places the contractual arrangement in a legal framework.

Findings – Evidence from the Seoul office market suggests that deposits can be very effective in protecting income return. In the UK during the down phase of the cycle, when supply of space exceeds demand and business conditions are uncertain, tenants are unwilling to pay deposits and landlords are more inclined to offer incentives in a bid to get the property let, even though the down phase is exactly the time when a deposit system is needed most. Landlords should be looking through the cycle and insisting that deposits are paid at the height of the market when their bargaining strength is stronger. The deposit should be sufficient to cover the probability of income loss in the down phase of the cycle. Based on market evidence in 2009, the amount of the deposit should be equal to at least 15 months rent.

Practical implications – The stability of the income return is one of the key features of real estate both as an investment and as security. The use of rental deposits is a practical and straightforward way of hedging the risk. The paper estimates the amount of deposit required and provides guidance on the key heads of terms, which should be included in a deposit agreement.

Originality/value – The estimation of rental deposits has very little coverage in the literature. At a time when income return is under pressure landlords need to be fully aware of the benefits of the deposit system and the key factors that need to be considered when estimating the amount of deposit necessary to offset tenant default risk.

Keywords Rent reviews, Income, Property management, Tenant default, Financial risk, South Korea

Paper type Research paper

1. Introduction

At its most basic level, income return depends on tenants paying their rent in full and on time. The stability of the income return is one of the key features of real estate both as an investment and as a security, but this stability is threatened by tenant default particularly during the down phase of the cycle, introducing the potential for

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considerable loss of income as a consequence of lengthy void periods and the costs associated with marketing, legal fees and tenant inducements.

Income return is affected by both systematic and specific risk factors. Systematic risks comprise for example, general economic conditions, finance rates, level of taxation and legislative changes. Normally of greater significance are the specific risk factors, such as, tenant, location, prospects for rental growth, building condition, obsolescence, letting risk and lease arrangements.

Some of the specific risk factors relate to the physical characteristics of the building, others are affected by the covenant strength of the tenant who is contractually obliged to pay the rent. Research by Hutchison *et al.* (2009) has shown that the risk of default differs between sectors and that on average the probability of financial distress increases for smaller and younger companies, and that is important that those involved in the pricing of property interests are aware of these differences.

However, not all of these differences appear to be priced by the market. The research showed that it is the combination of lease length with covenant strength, which is absolutely critical when pricing cashflow risk. The analysis of IPD data from 2003 to 2007 showed that it was only when covenant strength was combined with lease length that the impact on equivalent yields could be discerned. While in general the results support the rationale that higher risk covenants command higher yields, it was evident that in the early part of the analysis period, 2003 to 2004, the market added only a very small additional risk premium to reflect the differences in covenant strength. The risk of default was being largely ignored in a buoyant market and mispricing occurred. However, this was adjusted as the market entered the down phase of the property cycle, which was too late for many investors with their income return adversely affected by increasing levels of default.

In the UK, commercial rents have traditionally been paid quarterly or half-yearly in advance. While it is understood that deposits are not uncommon, for the majority of commercial letting transactions in the UK no deposits are paid, thus exposing the landlord to the full risk of default. In such a scenario, the loss of income impacts immediately default occurs, with no deposit in place to cover any shortfall in rent during the time it takes to repossess and relet the property.

In certain instances where there is high demand for a particular property, perhaps because of planning restrictions, a lump sum payment may be made by the tenant to secure the lease. This is often referred to as "key money" and in the UK is non refundable at the end of the lease, providing the landlord with a bonus capital sum prior to lease commencement. Key money is not the focus of this paper.

Landlords and tenants focus their energies on negotiating the key heads of the terms of the lease notably level of rent, repairing obligations, rent reviews and the length of the lease. The content of the lease document depends upon their respective bargaining positions. Rent and lease length are clearly crucial but where landlords are bargaining with a weaker covenant there is less advantage in granting a longer lease, as to have any value a long lease requires a strong covenant to support it. Companies with weaker covenants are required to set up guarantees, but it can often be those tenants who at the outset were less likely to default, who go into administration and end up losing their funds larger sums of money. An alternative way for landlords to insure their cashflow is to insist on a rental deposit and such an approach is the focus of this paper. To be effective rental deposits should be sufficient to cover any shortfall in rent during the void period as well as covering the costs associated with reletting. Clearly, such a system is unlikely to be popular among tenants, but negotiating

strength between the parties can wax and wane during the cycle and landlords need to be aware of the benefits of such a system and when to insist on its inclusion. The key question being asked in this paper is what level of deposit would be sufficient to help offset income risk as a result of tenant default.

In answering this question, section 2 considers the negotiating strength between the parties while section 3 examines the well established deposit system operating in South Korea to see if lessons learned could be applied to the UK market. Deposit agreements in the UK are considered in section 4. To estimate the amount of deposit that would be appropriate given different states of the market, simulation methodology is applied to a number of cash flow scenarios in section 5, followed by conclusions in section 6.

2. Negotiating strength

There is a marked absence of rigorous research on rental deposits in the UK and on parent company or personal guarantees. Research into rental and lease negotiations has focused on related issues such as the role of information in negotiations between property market participants, the effect of lease expiry on rental negotiations and within rental negotiations, the differences between rent reviews/lease renewals and open market lettings.

The possession of robust market information is crucially important in the negotiation process as participants use such information to anchor their bids and negotiating positions. Black and Diaz (1996) conclude that the analysis of data gathered through a series of experiments revealed that the use of property information led to the manipulation of both buyer opening offer and eventual settlement prices, thus indicating the use of such price information as a shortcut and its strong potential as an agent for bias.

McAllister and Tarbert (1999) analyse the rental negotiation process prior to lease expiry. They test the findings from earlier research that tenants may use the threat of lease termination at rental negotiations in order to obtain concessions in the rent or other incentives. The authors note that the bargaining process will often cause deviation from what they term as an equilibrium solution. In their analysis the concession level of the landlord will be a function of four variables comprising the expected landlord's cost of void, probability of tenant relocation, landlord's risk preference and the effects of the bargaining process.

Drawing on utility theory McAllister and Tarbert conclude that the risk averse or risk neutral landlord in a potential lease termination situation will always maximise his/her position by conceding an amount on the open market rental value provided that the landlord perceives the probability of lease termination to be greater than zero.

They also find that behavioural approaches to bargaining theory suggest that differences in individual negotiator's attributes, social contexts and cognitive biases will also affect the outcome of a negotiated rent setting process.

Within rental negotiations, the differences between rent reviews/lease renewals and open market lettings were examined by Crosby and Murdoch (2000). They argue that in both rent reviews and lease renewals the rental negotiations are usually on a one-to-one basis which contrasts with open market lettings where a full marketing process normally occurs.

At rent review/lease renewal, if there is an inability to agree, third parties may determine the rent at review or renewal. This contrasts with the case of an open market letting where the absence of agreement may cause the proposed deal to collapse.

The potential impact of cyclical variations is demonstrated in a recessionary environment, where the negotiating strength between landlords and tenants is rather different when landlords are faced with increasing vacancy rates and lengthening void periods and tenants are struggling to keep in business, let alone fund additional one off capital sums in the form of a deposit. In the down phase of the cycle, instead of insisting on deposits, landlords may be inclined to offer longer rent free periods and other incentives in a bid to get the property let. Conversely, tenants may be unwilling to pay deposits when business conditions are uncertain and access to bank credit to fund the deposit problematic. Thus, during a recession the requirement to pay a deposit may be difficult to introduce, even although this is exactly the time when a deposit system is needed most.

This suggests that landlords should be looking through the cycle and insisting that deposits are paid at the height of the market when their bargaining strength is stronger. The deposit should be sufficient to cover any income loss, which occurs in the down phase of the cycle. Current practice would seem to suggest that rental deposits are not uncommon in the UK commercial property leasing but that where they exist they amount to no more than three to six months rent. The empirical part of the research will address the issue of cyclical impacts on the potential for rental deposits.

3. South Korean lease contracts

In considering the wider introduction of a deposit system in the UK it is worth reflecting on practice in other international markets. Of particular interest is the system operating in the South Korean Seoul office market where the deposit system is well established. In South Korea there are three types of lease contracts in the property user market; the Jeonse, the Walse and a hybrid of the Jeonse and the Walse, known as the Jeonwalse.

The Jeonse is a unique Korean lease arrangement, in which the tenant pays an upfront deposit with no requirement for periodic rent payments. This upfront deposit is called a Jeonse deposit and it is normally 40-80 per cent of the property value. (Ambrose and Kim, 2003). During the renting period, the landlords can utilise that Jeonse deposit for private financial purposes but must return only the deposit at the end of the lease (less any damages) without interest payments. Therefore, the benefits to the landlord in compensation for forgoing the use of the property is the investment return on the deposit over the lease contract.

This Jeonse lease contract is very popular in the property user market in Korea. According to the Population and Housing Census Report of 2005, the total number of leased households in Korea is 7.06 million, out of which 3.56 million (50.4 per cent) are under Jeonse contracts (the remaining households are under monthly rents). Outside Seoul, 84.4 per cent of all Korean office leases use a Jeonse contract, while in Seoul the Jeonse ratio is only 22.8 per cent. The literature has attributed the popularity of Jeonse system to the underdevelopment of the long-term financing market in Korea. (Ambrose and Kim, 2003; Kim and Yang, 2006)[1].

An alternative lease type is the Walse lease contract (monthly rental lease contract) in which the tenant pays a "security deposit" and monthly rents[2]. The monthly rent is based on a certain percentage of the difference between the Jeonse deposit and the security deposit. The security deposit in the office market is normally equivalent to ten months rent. The monthly rent depends on the conversion rate which is defined as the rate of return that equates the profits from the Jeonse deposit to those from the monthly rental contract[3]. The deposit held by the landlord does not bear any interest during

the performance of this lease contract. In the event that the tenant does not pay the rent, or other required expenses by the date due, the landlord can offset unpaid expenses by the amount of the security deposit without consent of the tenant. In case of expiration of the lease term or termination of the lease contract, the landlord will refund the security deposit to the tenant after the leased premises are vacated and any expenses or debts are paid completely. If, however, there are other expenses or debts for which the tenant is liable, the balance remaining after deduction from the security deposit is refunded. The security deposit, rent and maintenance fee are reviewed every anniversary of the lease commencement date. The minimum lease period is two years (standard for most grade-A properties) and the maximum is less than five years. In the Seoul office market the Walse lease is the most common with around 77 per cent of all office leases contracted on this basis, with the Jeonwalse lease favoured by 19 per cent and Jeonse at 4 per cent. (R2Korea, 2009).

The third type of contractual arrangement, the Jeonwalse lease contract, incorporates elements of the Jeonse and Walse methods. It includes an initial security deposit that is higher than in normal Walse leases but less than the Jeonse deposit (normally 30-70 per cent of Jeonse deposit, but it depends on the contract) and a monthly rent that is lower than a Walse rent.

The choice of the lease contract types is determined by the ability of property developers (or investors) to raise finance. The long-term financing market in Korea has been underdeveloped and landlords have tended to choose the Jeonse or Jeonwalse lease contract for the financing of real estate projects or investments. In such cases the Jeonse deposit is normally used for paying off construction loans or purchasing other real estate properties. From a tenant's perspective the selection of the lease contract type also depends on their ability to raise finance for the Jeonse deposit. If they can finance their Jeonse deposit with lower interest rate than the conversion rate, they prefer to have a Jeonse or Jeonwalse contract than Walse. The selection of the lease contract types is influenced not only by the availability of finance and interest rates, but by the strength of the letting market and the negotiating power of the tenants and this will be discussed later in the paper.

Worldwide comparison

In most countries, except for Japan which demands ten months deposit, similar to South Korea, "Walse type deposits" amount to two or three months' rent, which will be returned at the end of the lease exclusive of the deferred rent and the repair cost. Table I details the amount of deposit that is normal in selected countries.

Table I.
Use of deposits in selected countries

Country	Deposit
Korea	10 months rent
Japan	10 months rent
Germany	3 months rent or bank guarantee equal to 3 months rent
Czech	3 or 6-month cash deposit or bank guarantee
Hungary	3 months gross rent or bank guarantee
Singapore	3 months gross rent
China	3 months net rent + management fees
USA	2 months rent
UK	3 or 6 months rent

As mentioned above, the selection of the lease contract types is partly influenced by the strength of the letting market and the negotiating power of the landlords and tenants. An analysis of the vacancy ratio is a good indicator of the supply and demand levels in the market and provides an insight into likely negotiation strengths.

Figure 1 compares the vacancy rate in Seoul with other selected Asian office markets as of December 2008, and shows that the vacancy ratio in the Seoul office market was at a very low level in comparison with other international markets. In that scenario, tenants have very little bargaining power due to excessive demands for office space. Therefore, the landlords often demand short lease terms to allow for possible future expansions and easily find tenants willing to accept their terms, especially for well-located tenancies.

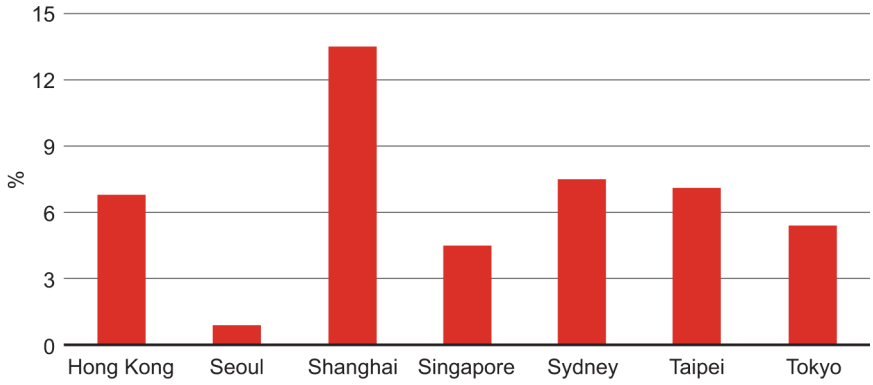
It is fully acknowledged that market practice in South Korea is not directly comparable to the UK market. Nevertheless, it does illustrate in a fairly extreme way (from a UK perspective), how a deposit system can be used to protect income return in the event of default. That a tenant is willing to pay such large capital sums in lieu of all or part of the rent indicates the strength of the letting market and the negotiating power of the respective parties.

4. Deposit agreements in the UK

Where the tenant agrees to provide a deposit in the UK, the terms under which the deposit is held and applied are normally regulated by a deposit agreement between the landlord and tenant.

The deposit agreement should cover the key points outlined in Table II.

As an alternative to a deposit, a landlord who has concerns over the prospective tenant's covenant may require that the tenant provide a guarantee from a third party for the performance of the tenant's obligations. A typical example would be a guarantee given by the directors or parent company in relation to a company with limited trading history. Clearly, the landlord will require to be satisfied with the covenant of any proposed guarantor. The availability and terms of any guarantee will generally be a matter for negotiation in individual cases and landlords may encounter resistance to any guarantee request.



Source: Jones Lang LaSalle (2009)

Figure 1.
Vacancy rate in selected Asia Pacific office markets as of December 2008

1.	Amount of deposit	This is a matter for negotiation. See below
2.	Duration of deposit	On shorter leases the deposit will normally remain in place for the entire period of the lease. On longer leases, the Agreement may provide for the deposit to be repaid after a defined period or on the tenant satisfying agreed criteria in relation to its covenant strength
3.	Holding the deposit	The deposit sum should be paid to the landlord on commencement of the lease with the funds being placed in a separate interest-bearing account in the landlord's name The Agreement will normally state that the deposit sum is held by the landlord on trust to safeguard the tenant's right to repayment of the deposit sum against the risk of the landlord's insolvency
4.	Interest	The Agreement will normally state that the tenant is entitled to any interest earned on the deposit sum
5.	Withdrawals by Landlord	The landlord should have the right to withdraw funds from the deposit sum to meet: any overdue rent or other payments due under the lease (e.g. service charges, insurance premiums); and any costs incurred by the landlord in making good any breach of the tenant's non-monetary obligations, e.g. failure to comply with a repairs notice The Agreement may also provide for the landlord being entitled to keep the deposit in the event of the lease being irritated or the tenant's insolvency The Agreement will normally impose an obligation on the tenant to top-up the deposit following any permitted withdrawal by the landlord
6.	Return of deposit	Unless the Agreement provides for earlier repayment, the landlord will be required to return the deposit and accrued interest to the tenant (less any permitted withdrawals) on expiry of the lease, subject to the tenant having complied with its obligations under the lease

Table II.
The deposit agreement

The landlord may require that the guarantor gives a "blanket" guarantee covering the performance of all the tenant's obligations throughout the lease period to include an undertaking by the guarantor to enter into a replacement lease in the event of the tenant's insolvency. The guarantor on the other hand may look to restrict their insolvency guarantee. This may involve:

- limiting the period of the guarantee;
- limiting the guarantee to defined obligations, e.g. payment of rent; and
- limiting the maximum sum recoverable under the guarantee, or any combination of these restrictions.

From the landlord's perspective a guarantee from a financially sound guarantor may offer greater comfort than a deposit arrangement. The advantage of the deposit is that a properly drawn Deposit Agreement will allow the landlord "instant access" to the deposit sum following tenant default whereas obtaining payment from a guarantor may involve formal enforcement procedures.

However, if the deposit sum has been fully applied by the landlord in meeting rent or other arrears, the reality is that a landlord faced with a tenant in financial difficulties may struggle to obtain any top-up payment from the tenant and the landlord's remedies for further tenant breaches are enforcement action against the tenant under the lease or irritancy of the lease.

5. Calculating the level of deposit – scenario testing

The amount of the deposit required to compensate for default is a function of the loss of income and expenses, which then ensue. The amount of the loss depends upon the timing of the default, the length of the void period, the amount of incentives that are required to be offered to a new tenant and the cost of marketing the property along with the legal costs involved in setting up the new lease. (Legal costs may also be incurred in pursuing the defaulting tenant for unpaid rent and seeking repossession of the property, but for illustrative purposes these are ignored in this paper.)

In order to calculate the appropriate level of deposit it is necessary to consider a number of different scenarios. The variables that need to be considered are listed in Table III, along with some illustrative inputs for scenario testing purposes[4].

The purpose of the scenarios is to estimate the level of deposit that would compensate for tenant default occurring at different time periods during the lease and under certain assumptions on the loss of income that would then occur due to void and rent free periods.

In the first instance a benchmark valuation was undertaken representing the value of the investment assuming no default occurred during the holding period. (Costs of purchase are ignored.) Thereafter, nine different scenarios were assumed, based on the tenant defaulting at the end of each year from year one to year nine. Whenever the default occurs it is assumed that the investor has a ten-year holding period.

In each of these scenarios two different conditions of the market were assumed, a Recessionary Market and a Recovery Market. In the Recessionary Market scenario it is envisaged that in the event of default there will be a 12-month void period and at the end of this period a new ten-year lease is agreed but that a 12-month rent free period is required in order to encourage the tenant to sign up – hence, in total, 24 months of income is lost. In the Recovery Market it is assumed that there will be no void period but for the reasons mentioned above a 12-month rent free period is still required and thus in total 12 months of income is lost. At the end of 2008, the average age of vacancies varied by sector with, for example, West End offices at 12.3 months, Industrial Rest of UK at

Initial rent-free period	12 months
Passing rent	£100,000 per annum
Lease length	10 years
Rent review period	Every five years, upward only
Initial yield	8%
Target rate of return	10%
Implied annual growth	2.33%
Holding period	10 years
Marketing and legal costs	5% of revised rent
Length of void period	Up to 12 months
Tenant incentives	12 months rent-free
Exit yield	8%

Table III.
Assumptions: UK market example

20.1 months and Retail Warehouses at 18.2 months (IPD, 2009). In 2007/2008 the All Property average rent free period weighted by rent passing was 9.5 months (IPD, 2008).

In each of the 18 different scenarios, the NPV's were calculated and the resultant figure then deducted from the benchmark NPV in order to show the amount of deposit required to fully compensate for the default. In the Table IV columns 3 and 6 show the amount of deposit required to compensate for the default expressed as a multiplier of the initial annual market rent. Thus, if default was to occur at the end of year 1 under the Recessionary Market hypothesis, in order for the landlord not to suffer any financial loss he would require to have obtained a deposit at the beginning of the lease of 1.6 times the initial annual market rent. The multiplier under the Recovery Market hypothesis is 0.85.

What do the results tell us? Where landlords have granted incentives such as rent-free periods, contributions to fitting out works or reverse premiums, default during the early years of the lease is particularly damaging to the value of the investment. The earlier this occurs during the lease, the bigger the impact on the NPV. While the level of deposit required reduces the later default occurs, the results are not linear due to the timing of rent reviews and the impact of discounting (see Figure 2). For example, under the Recessionary Market scenario, if default occurs at the end of year 3, a 12-month void period is assumed (year 4) and a new rent agreed at the beginning of year 5, based on rental growth over four years, with the fifth year being rent free. Compare this with default at the end of year 5, a 12-month void period is assumed (year 6) with new rent agreed at the beginning of year 7, based on rental growth over six years, with the seventh year rent free (see Figure 2).

Calculating the level of deposit – Monte Carlo simulation

In the above example the growth rate used was based on the implied annual growth rate. When using an implied growth rate there is little difference in the results whether a higher or lower initial yield is used, given a fixed target rate of return.

Table IV. Results of scenario testing

	Recessionary Market (24-month loss of income)			Recovery Market (12-month loss of income)		
	NPV (£) (1)	Deposit required (£) (2)	Multiplier of market rent as a deposit (3)	NPV (£) (4)	Deposit required (£) (5)	Multiplier of market rent as a deposit (6)
Control valuation: no default	1,159,091			1,159,091		
Default event: end of year						
1	999,168	159,923	1.60	1,074,051	85,040	0.85
2	1,012,151	146,940	1.47	1,081,813	77,278	0.77
3	1,022,478	136,613	1.37	1,087,283	71,808	0.72
4	1,030,492	128,599	1.29	1,090,779	68,312	0.68
5	1,036,501	122,590	1.23	1,092,584	66,507	0.67
6	1,047,667	111,424	1.11	1,099,840	59,251	0.59
7	1,056,712	102,378	1.02	1,105,248	53,843	0.54
8	1,063,907	95,184	0.95	1,106,741	52,349	0.52
9	1,071,698	87,393	0.87	1,111,495	47,596	0.48
Average deposit			1.21			0.59

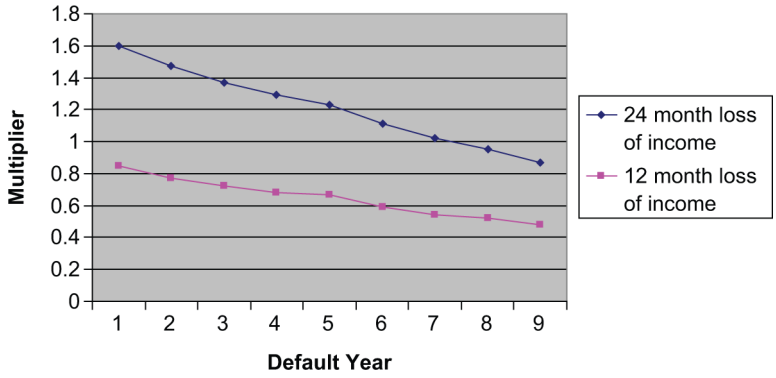


Figure 2.
Multiplier of market rent required as a deposit

A more sophisticated way of illustrating the effects of default is using a simulation model using the Monte Carlo technique. The Monte Carlo simulation was carried out using a Microsoft Excel spreadsheet with a risk analysis "add in" Crystal Ball (www. Oracle.com). Crystal Ball offers a range of distribution functions but for simplicity a triangular distribution was used. The triangular distribution can mimic the moments of a number of popular distributions among statisticians and the inputs are easily understood by practitioners. The parameters of the triangular distribution are minimum, most likely and maximum value and the parameters used in the worked example are shown in Table V. For the purpose of illustration the growth rate, yield, and target rate of return were treated as random variables, with the level of deposit required the forecast variable.

The data used in the simulation were the same as shown in Table III. A total of 50,000 simulations were run to estimate the average deposit required, based on both states of the market and the results are shown below. The results are detailed in Table VI.

Table VII illustrates the probability distribution of the average deposit required. While these figures still require interpretation by the investor, they certainly provide

	Minimum (%)	Likeliest (%)	Maximum (%)
Growth rate	0	3	4
Initial yield	7	8	9
Target rate of return	9	10	11

Table V.
Parameters for the random variables

	Average deposit – multiplier of market rent Recessionary Market (24-month loss of income)	Average deposit- multiplier of market rent Recovery Market (12-month loss of income)
Mean	1.20	0.64
Standard deviation	0.09	0.09
Maximum	1.48	0.91
Minimum	0.87	0.32
Range width	0.61	0.59

Table VI.
Results of the simulation

Table VII.
Frequency probability of deposit being greater than indicated

Probability (per cent)	Recessionary market (24-month loss of income)	Recovery market (12-month loss of income)
90	1.08	0.52
80	1.13	0.56
70	1.16	0.59
60	1.18	0.62
50	1.21	0.64
40	1.23	0.66
30	1.25	0.69
20	1.28	0.72
10	1.32	0.76

more information compared to single point estimates produced by conventional methods. For example there is a 70 per cent chance that the deposit requited will not exceed a multiplier of 1.25 of the initial market rent based on the recessionary market assumptions.

Wider implementation of a deposit system in the UK?

The UK commercial property market is significantly different from that of South Korea. Vacancy levels for central London offices rose to between 8 per cent and 10 per cent in 2009 (GVA Grimley, 2010), compared with 4.3 per cent in Seoul (R2Korea, 2009)), thus, the negotiating positions of the landlord and tenant in the respective countries are very different. In a utopian world, landlords would want a deposit backing every lease as securing a deposit agreement provides greater security of income, which may in turn attract a lower yield, improving the capital value of the investment.

The reduction in lease length and increase in the number of tenant led break options over the last ten years bear witness to the fact that most tenants have considerable negotiating power in the UK (IPD, 2009). In such a scenario it is not surprising that tenants view a deposit as unwelcome, unless agreeing to a deposit improves their negotiation position over other lease terms or perhaps allows them access to a property location that would previously have been denied them.

The inclusion of a deposit payment in lease negotiation forms just one part of the overall heads of terms and its inclusion may result in concessions being made on other lease conditions. For example, in a poor letting market a landlord may agree to a slightly reduced rent in return for a deposit being paid, thereby accepting a lower level of income for increased security of income. Tenants with a strong covenant, such as anchor tenants in a shopping centre, will be able to negotiate away any need to pay a deposit while weak covenants may find their negotiation position compromised and have to agree to enter into a deposit agreement in order to be allowed to occupy the space. The actual amount of the deposit demanded may depend on their specific credit rating. Further research is required to fully understand the emphasis placed by landlords and tenants on the various heads of terms on offer in a new letting scenario and how they might interplay.

From a landlord's perspective, deposits are really only relevant if there is a likelihood of default. It is not suggested in this paper that all new leases in the UK should have deposits, but occupiers in certain sectors are more prone to default (Hutchison *et al.*, 2009) and landlords need to be aware of the probability of default and of delinquency during

the investment holding period and, if appropriate, seek a suitable level of deposit at the start of the lease to hedge against this risk. The level of company liquidations in England and Wales in 2009 was around 1 per cent of all the active companies on the register but this is expected to show a sharp rise in 2010 as the full effects of the recession are felt. Where a deposit is sought it should be sufficient to cover all loss of income following default until the property is revenue producing once again.

6. Conclusion

The stability of income return is key to property investment performance. During the down phase of a property cycle income return is under pressure as tenant default increases, rental rates decline, void periods lengthen and tenants demand longer rent free periods. Rental deposits, if of sufficient size, can act as an important insurance policy in the event of default. However, rental deposits are not standard in all UK lease arrangements and where they do exist tend to be only to the value of three to six months rent. The amount of any deposit is agreed when the heads of term of the lease are negotiated and is a function of the bargaining strength of the parties. During the down phase of the cycle, when supply of space exceeds demand, landlords are not in a position to insist on rental deposits and tenants, with a choice of locations, are simply unwilling to pay out further capital sums when business conditions are uncertain and access to bank credit problematic.

Evidence from the Seoul office market suggests that deposits can be very effective in protecting income return. In a market where vacancy levels are low and landlords have the upper hand in any negotiations, the Walse lease structure dominates with the tenant required to pay ten months rent as a security deposit. While it is recognised that direct comparison between the UK and the Seoul office market is not possible, the study reveals the central role that security deposits play in a landlord led market. Moreover, compared to UK practice, the amount of deposit is significantly higher both in cash terms and as percentage of the lease term – ten months rental deposit aligned with a lease length of two to three years.

The clear lesson from such a comparison is that UK landlords should be looking through the cycle and insisting that deposits are paid at the height of the market when their bargaining strength is stronger. In theory, the deposit should be sufficient to cover the probability of income loss at any time during the holding period of the investment. Based on market evidence in 2009, the amount of the deposit should be equal to at least 15 months rent in a recessionary market and six months rent in the recovery phase. In reality, such an increase from current levels may be difficult to achieve but establishing the security deposit as the norm in UK leases and then making incremental increases to the amount of the deposit would go a significant way to protecting the income return when the downturn arrives.

Notes

1. The reason for the underdevelopment of long-term financial market was the underdevelopment of formal financial services and government interventions on interest rates. During the period of government-led development, the Korean government kept interest rates low for business firms. These interventions inevitably imposed higher-than-equilibrium interest rates on consumer credit and housing finance in the formal financial market.

2. For the Walse system, the landlord would establish the amount of the Jeonse deposit and then convert it into monthly rent using the conversion rate (Lee *et al.*, 2002).
3. (Lee *et al.*, 2002) found out in their research that the conversion rate can be understood as the required rate of return of the invested equity in property rather than the market interest rate. According to R2Korea DB the average conversion rate for the CBD is 13.5 per cent.
4. It is recognised that "steady state" assumptions on the inputs may understate the range of likely outcomes. Later in the paper, a Monte Carlo simulation technique is used to make allowances for the possible range of key inputs such as the growth rate.

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Further reading

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